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CERTAIN REGULATED INVESTMENT COMPANIES

December 14, 1970.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. Burke of Massachusetts, from the Committee on Ways and Means, submitted the following

REPORT

[To accompany H.R. 6742]

The Committee on Ways and Means, to whom was referred the bill (H.R. 6742) to amend the Internal Revenue Code of 1954 to provide a longer period of time for disposition of certain assets in the case of regulated investment companies furnishing capital to development companies, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

Page 3, line 22, strike out "paragraph" and insert "paragraphs".

Page 5, strike out line 24 and all that follows down through line 20 on page 6 and insert:

subparagraph.

"(6) Termination of status.—If a corporation meets the requirements of subsection (b)(4)(A) at the close of any quarter of any taxable year (whether beginning before, on, or after the date of the enactment of this paragraph) by reason of the application of the foregoing provisions of this subsection, subsection (d) shall not apply to such corporation for any subsequent quarter of any taxable year (beginning after the date of the enactment of this paragraph) for which the Securities and Exchange Commission fails to make the determination provided for in paragraph (1) or for which the corporation fails to satisfy the limitation set forth in paragraph (2)(A) or the limitation set forth in paragraph (2)(B)."

(b) The amendment made by subsection (a) shall apply to taxable years beginning on or after January 1, 1967; except that section 851(e)(6) (as added by subsection (a)) shall apply only with respect to taxable years beginning after the date of the enactment of this Act.

I. SUMMARY

H.R. 6742 provides that so-called development companies (established to provide funds for corporations marketing new products) which are taxed as regulated investment companies (mutual funds) must dispose of their excess holdings in such corporations within a

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20-year period (instead of the 10-year period under present law) to the extent the holdings represent more than 25 percent of their investments. However, for this treatment to be available beginning with the 15th year such companies must dispose of at least 40 percent of their excess holdings of stock by the end of the 15th year. Companies which once met the statutory requirements to qualify as regulated investment companies through the application of the special development company rules, and which fail to meet these limitations for any quarter, may not have the benefit for that quarter of a savings clause which under existing law applies to regulated investment companies.

Provisions which were identical in substance to the provisions of this bill passed both the House (H.R. 15023) and the Senate (S. 2767) in 1968, but neither of those bills was enacted.

This bill is reported unanimously by your committee, and the Treasury Department has indicated it has no objection to its enactment.

II. REASONS FOR BILL

Present law treats electing regulated investment companies (mutual funds) as conduits, taxing these corporations only on the income which they retain and do not distribute to shareholders. The shareholders of the corporations, of course, are taxable on the dividends they receive.

Included in the qualifications for regulated investment companies is a requirement that they diversify their investments within prescribed limits. They must invest at least 50 percent of their assets in cash, cash items, and certain corporate securities. These securities, in respect of any one issuer, may not represent more than 5 percent in value of the companies' total assets or more than 10 percent of the outstanding voting stock of the issuer. These valuations are made on a quarter-by-quarter basis. Investments in securities which do not come within the prescribed 5- and 10-percent limits do not count toward fulfilling the overall 50-percent test.

An exception to the 5- and 10-percent limits applies in the case of so-called development companies. A development company is one which is principally engaged in furnishing capital to other corporations which themselves are "principally engaged in the development or exploitation of inventions, technological improvements, new products, or products not previously generally available to the public." For a company to qualify as a development company and thus be eligible for the exception, it must receive the certification of the Securities and Exchange Commission that it is investing in the prescribed type of corporations.

A company which receives SEC certification as a development company under limited circumstances may include investments in securities of one or more issuers in excess of the 5- and 10-percent limits toward fulfilling the overall 50-percent investment diversification test. The company may do so if the cost (or other tax basis) of the investment in the particular issuer, at the time of the latest acquisition of any securities of an issuer did not then exceed 5 percent of the value of the development company's total assets. This valuation is made only at the time of the initial investments. The exception to the regular 5- and 10-percent limits only applies for investments in the securities of any one issuer during a period of 10 years from the time of the first investment in the securities of that issuer.

The exception to the 5- and 10-percent limits described above applies for development companies only where a special 10-year rule is complied with. Thus the development company may not maintain its special status where more than 25 percent of the value of its assets is represented by securities of one or more issuers in which it has held an interest for 10 years or more and in each of which the development company's holdings exceed the regular 10 percent limit on investments in these companies.

As a result of this special limitation, a development company which under SEC certification otherwise could continue to make investments in excess of the 5- and 10-percent limits cannot do so where more than 25 percent of the value of its assets is in the specified securities held for over 10 years. However, the company may continue to qualify as a regulated investment company by reason of a savings provision in present law. This provision, in effect, provides that a company which once qualifies as a regulated investment company is not to lose its status as such except through the acquisition of securities or other property. The anomaly of this result is that a company whose basis for being taxed as a regulated investment company was that it operated as a development company may continue to be taxed as such even though in effect the company may no longer meet the requirements of a development company.

The attention of your committee has been called to a situation under present law in which the provisions described above are operating in a way which frustrates the intended investment activities of a publicly held certified development company. One out of a current portfolio of approximately 40 investments of the development company referred to has appreciated in value to the extent that this investment in the securities of one issuer represents in terms of value more than 25 percent of the company's assets and these securities have been held for more than 10 years. As a result the company no longer complies with the special 25-percent rule and therefore must (1) distribute the securities to its shareholders, (2) sell the "excess" securities (i.e., its holdings over the 25 percent held for over 10 years), or (3) retain the securities and retain its regulated investment company status under the general savings provision by not making new investments of the type it ordinarily makes.

Neither the first nor the third alternatives noted above are in accord with the statutory purpose of the development company tax provision. Distributing the securities to the development company's shareholders would not provide the company with funds for investment in corporations engaged in developing or exploiting new products. Similarly, the company's refraining from future investments also would not provide funds for investments in these corporations. However, the second alternative available to the development company, that of selling all its "excess" securities, simply is not practical from the company's or its shareholders' standpoint. The securities represent a significant interest in the issuer, and a forced sale of all the securities could be expected to provide substantially less than the current fair market value of the securities. What the company in the absence of legislation is doing, therefore, is selling the securities in relatively small blocks. This procedure will provide the company with funds for investments in other corporations marketing new products and accords with the statutory purpose of the development company tax provisions.

Your committee concluded that the solution to the problem described above is to give the development company time to market its investment in an orderly fashion. Your committee also concluded that in the future a development company which fails to meet the new limitations adopted by your committee should not be able to continue to qualify as a regulated investment company by applying the so-called savings provision referred to above.

III. EXPLANATION OF BILL

As explained above, existing law provides that a company may not qualify as a development company if more than 25 percent of the value of its assets is in securities of issuers with respect to each of which the company exceeds the prescribed 10-percent limit on investments and with respect to each of which the company has held securities for a continuous 10-year period. This bill extends the 10-year period to 20 years. It does so, however, only if the company evidences its intention to comply with the 25-percent limit by the close of the 15th year and continues to do so at the end of subsequent years. The company must evidence this intention by reducing the value of its excess holdings in these issuers by at least 40 percent (i.e., 40 percent of the difference between the aggregate value of the holdings and 25 percent of the value of the development company's total assets). The reduction must be either on a pro rata basis with respect to each security of the various issuers or to the extent not pro rata it must be in those securities where the appreciation in value since the time of acquisition has been above the average. Thus the company cannot comply with the bill, and thereby continue to qualify as a development company, by disposing of those securities which would result in the smallest taxable gain.

Under the bill if at the close of the 15th year (and at the close of of each year thereafter) a development company has not reduced its excess holdings by the prescribed 40-percent amount the company does not qualify as a development company for that year, unless at that time these securities which it has held 10 or more years then do not constitute more than 25 percent of the value of its total assets. Under the bill the company may not use the general savings provision to qualify as a regulated investment company for that year. If the company does reduce its excess holdings by the prescribed amount (or if these holdings constitute 25 percent or less of the value of its total assets), the company may continue to qualify as a development company so long as it continues at the close of each year to meet one of these tests applicable to securities it has held for 10 or more years. Also under the bill at the close of the 20th year in order to continue to qualify as a development company, the value of the securities which it has held for 20 or more years must not in any event exceed 25 percent of the value of its total assets. As in the case of the new limitation which becomes first applicable at the end of the 15th year, if the company fails to meet the limitation on its holdings of 20-year securities, the company does not qualify for that year as a development company and cannot use the general savings provision to qualify as a regulated investment company for that year.

The amendments made by this bill apply with respect to taxable years beginning on or after January 1, 1967, except that the prohibition against reliance on the general savings clause in order to qualify as a regulated investment company applies to taxable years beginning after the date of enactment.

IV. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

SECTION 851 OF THE INTERNAL REVENUE CODE OF 1954

SEC. 851. DEFINITION OF REGULATED INVESTMENT COMPANY.

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(e) INVESTMENT COMPANIES FURNISHING CAPITAL TO DEVELOPMENT CORPORATIONS.—

(1) GENERAL RULE.—If the Securities and Exchange Commission determines, in accordance with regulations issued by it, and certifies to the Secretary or his delegate not earlier than 60 days prior to the close of the taxable year of a registered management company, that such investment company is principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, such investment company may, in the computation of 50 percent of the value of its assets under subparagraph (A) of subsection (b)(4) for any quarter of such taxable year, include the value of any securities of an issuer, whether or not the investment company owns more than 10 percent of the outstanding voting securities of such issuer, the basis of which, when added to the basis of the investment company for securities of such issuer previously acquired, did not exceed 5 percent of the value of the total assets of the investment company at the time of the subsequent acquisition of securities. The preceding sentence shall not apply to the securities of an issuer if the investment company has continuously held any security of such issuer (or of any predecessor company of such issuer as determined under regulations prescribed by the Secretary or his delegate) for 10 or more years preceding such quarter of such taxable year.

[(2) LIMITATION.—The provisions of this subsection shall not apply at the close of any quarter of a taxable year to an investment company if at the close of such quarter more than 25 percent of the value of its total assets is represented by securities of issuers with respect to each of which the investment company holds more than 10 percent of the outstanding voting securities of such issuer and in respect of each of which or any predecessor thereof the investment company has continuously held any security for 10 or more years preceding such quarter unless the value of its total assets so represented is reduced to 25 percent or less within 30 days after the close of such quarter.]

(2) Limitations.—

(A) Excess investments after 15 years.—If—

(i) at the close of any taxable year (whether beginning before, on, or after the date of the enactment of this subparagraph), more than 25 percent of the value of the total assets of an investment company is represented by securities of issuers with respect to each of which the investment company holds more than 10 percent of the outstanding voting securities of such issuer and in respect of each of which or any predecessor thereof the investment company has continuously held any security for 10 or more years, and

(ii) at the close of the fifth taxable year following such taxable year (but only if such fifth taxable year begins after the date of the enactment of this subparagraph), the investment company has not reduced by at least 40 percent its holdings of each issue of securities described in clause (i) which represented the excess investment in such securities (as determined under paragraph (5)),

the provisions of this subsection shall not apply at the close of any quarter of such fifth taxable year to such investment company, unless at the close of such year the securities described in clause (i) represent 25 percent or less of the value of its total assets (or are reduced to 25 percent or less of such value within 30 days thereafter).

(B) Excess investments after 20 years.—The provisions of this subsection shall not apply at the close of any quarter of a taxable year to an investment company if at the close of such quarter more than 25 percent of the value of its total assets is represented by securities of issuers with respec to each of which the investment company holds more than 10 percent of the outstanding voting securities of such issuer and in respect of each of which or any predecessor thereof the investment company has continuously held any security for 20 or more years preceding such quarter unless the value of its total assets so represented is reduced to 25 percent or less within 30 days after the close of such quarter.

(3) Determination of status.—For purposes of this subsection, unless the Securities and Exchange Commission determines otherwise, a corporation shall be considered to be principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, for at least 10 years after the date of the first acquisition of any security in such corporation or any predecessor thereof by such in-

vestment company if at the date of such acquisition the corporation or its predecessor was principally so engaged, and an investment company shall be considered at any date to be furnishing capital to any company whose securities it holds if within 10 years prior to such date it has acquired any of such securities, or any securities surrendered in exchange therefor, from such other company or predecessor thereof. For purposes of the certification under this subsection, the Securities and Exchange Commission shall have authority to issue such rules, regulations and orders, and to conduct such investigations and hearings, either public or private, as it may deem appropriate.

(4) DEFINITIONS.—The terms used in this subsection shall have the same meaning as in subsections (b) (4) and (c) of this section.

(5) RULES FOR APPLICATION OF PARAGRAPH (2)(A).

(A) EXCESS INVESTMENT.—For purposes of paragraph (2)(A), the excess investment with respect to any issue of securities described in clause (i) of such paragraph held by an investment company is an amount equal to an amount determined by multiplying—

(i) the aggregate value of the securities described in clause (i) of such paragraph, reduced by an amount equal to 25 percent of the value of the total assets of the investment company, by

(ii) a fraction the numerator of which is the value of such issue of securities and the denominator of which is the aggregate value of all securities described in such clause (i) held by the investment company.

(B) SUBSTITUTION FOR LESS-APPRECIATED SECURITIES.—If the percentage appreciation in value per share of any issue of securities described in clause (i) of paragraph (2)(A) is less than average percentage appriciation in value per share of all issues of securities described in such clause, the reduction, or any part thereof, in the holdings of such issue required under clause (ii) of paragraph (2)(A) shall be treated as satisfied by a reduction (in addition to the reduction required under such clause) of a dollar amount of the holdings of any other issue of securities described in clause (i) of such paragraph, the average appreciation in value per share of which is higher than the average appreciation in value per share of all issues of securities described in such clause, equal to the dollar amount of such issue which would have to be disposed of to effectuate such reduction or such part. This subparagraph shall apply only if the investment company files a statement, at the time of making its return for the taxable year, identifying the transaction or transactions in which its holdings of such other issue were reduced in substitution for a reduction in the holdings of such issue.

(C) TIME FOR MAKING DETERMINATIONS.—For purposes of subparagraph (A) of this paragraph and clause (ii) of paragraph (2)(A), all determinations shall be made as of the close of the applicable taxable year referred to in clause (i) of paragraph (2)(A). For purposes of applying subparagraph (B) of this paragraph, all determinations shall be made at the time of the transaction identified by the investment company under such subparagraph.

(6) TERMINATION OF STATUS.—If a corporation meets the requirements of subsection (b) (4) (A) at the close of any quarter of any taxable year (whether beginning before, on, or after the date of the enactment of this paragraph) by reason of the application of the foregoing provisions of this subsection, subsection (d) shall not apply to such corporation for any subsequent quarter of any taxable year (beginning after the date of the enactment of this paragraph) for which the Securities and Exchange Commission fails to make the determination provided for in paragraph (1) or for which the corporation fails to satisfy the limitation set forth in paragraph (2)(A) or the limitation set forth in paragraph (2)(B).

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